No. 92-1384

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,

Respondent.

On Writ Of Certiorari To The Court Of Appeal Of The State Of California In And For The Third Appellate District

BRIEF FOR BANQUE NATIONALE De PARIS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF AMICUS

Banque Nationale de Paris ("BNP") hereby respectfully files this Amicus Curiae Brief in Support of Petitioner Barclays Bank PLC. BNP has received the consent of both parties to file this Amicus brief.

BNP is a French banking corporation which was owned by the French government until November, 1993, when it became a public corporation. It engages in worldwide banking activities both directly and through subsidiaries. For taxable years 1976 through 1988 BNP maintained an agency (an office) in California and filed California franchise tax returns reporting the income shown on the books of the California agency. BNP also owned a California-based banking subsidiary now called Bank of the West ("BOW"), which filed separate California franchise tax returns for taxable years 1976 through 1988. The California Franchise Tax Board ("FTB") has issued Notices of Proposed Assessment of Additional Franchise Tax (NPAs) for 1976-1980 and for 1983-1988[1] to both BNP and BOW based upon worldwide combination of BNP and all of its subsidiaries.

The deficiencies proposed by the FTB and protested by BNP and BOW arise from three separate elements: (1) the FTB calculated combined worldwide income of the BNP unitary group based on foreign financial accounting statements; (2) the FTB disallowed certain expenses (such

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[1] The statute of limitations expired for income years 1981 and 1982 for BNP without issuance of any proposed assessments. Proposed assessments were issued BOW for these years after the expiration of the statute of limitations, but were later withdrawn for that reason.

as the bad debt deduction) contained in the foreign financial accounting statements; and (3) the FTB made certain adjustments to information obtained from foreign financial accounting statements for purposes of computing an apportionment formula.

ARGUMENT

Application of California's worldwide combined reporting system is significantly different for foreign parent groups than for domestic parent groups. These differences include greatly disproportionate burdens of compliance, unequal treatment in the determination of taxable income for identical transactions, and unequal calculation of apportionment factors for identical economic activity. These differences explain why foreign governments and foreign corporations protest California worldwide combination.

FOREIGN GOVERNMENTS AND CORPORATIONS LEGITIMATELY BELIEVE THAT CALIFORNIA'S SYSTEM OF WORLDWIDE COMBINED REPORTING AS APPLIED DISCRIMINATES AGAINST FOREIGN PARENT GROUPS.

The U.K. government has a keen and legitimate interest in the methods used by California to tax both Barclays Bank PLC, a U.K. corporation, and Barclays Bank of California, a California corporation (collectively referred to as

"Barclays").[2] In contrast, the U.K. government has no particular interest in how California taxes a U.S. based enterprise such as Container Corporation of America, whether or not Container owns a subsidiary organized under U.K. law.

The California system of foreign parent worldwide combined reporting offends both foreign governments and corporations because the system creates undue compliance burdens and unfair results for the foreign corporation. The interest of a foreign government with respect to its own domestic enterprises and the unequal treatment imposed by California's system of combined reporting create a situation which compels foreign governments to protest or threaten retaliation.

A. The administrative burden of filing a California worldwide combined tax return is significantly higher for foreign parent combinations.

A worldwide combined tax return requires a taxpayer to record and retain information sufficient to determine income under California tax accounting rules, Cal. Code Regs. tit. 18, § 25137-6(b), and to calculate an apportionment formula, Cal. Code Regs. tit. 18, § 25137-6(c). This information is maintained in the ordinary course of business by U.S. parent corporations and by U.S. subsidiaries of foreign parents. U.S. parent corporations require

[2] The on-going U.S. trade dispute with Japan illustrates the interest of the U.S. federal government in the foreign treatment of domestic corporations and foreign subsidiaries of the domestic corporations.

information from their foreign subsidiaries to prepare consolidated financial statements. The information maintained by foreign parent corporations and by foreign subsidiaries of foreign parent corporations may or may not be recorded under standards required by the Franchise Tax Board regulations, particularly where foreign accounting principles differ from comparable U.S. accounting principles. Moreover, backup documentation is usually maintained in the language of the foreign parent, and a foreign parent and its non-U.S. subsidiaries do not determine their record retention policies based on California tax compliance requirements.[3]

Because foreign parents do not maintain records to file a California worldwide combined report as a matter of course, a significantly higher administrative burden is placed on foreign parents.

Two examples illustrate the disparate burden. The first example illustrates the additional burden faced by a foreign bank in computing income subject to apportionment. Both foreign and domestic banks look to Cal. Code Regs. tit. 18, § 24348(b) for rules determining how banks can take a bad debt deduction. An acceptable method peculiar to California is to allow a deduction for an addition to the reserve for bad debts by an amount needed to absorb anticipated future losses (but for some years not to exceed one percent of outstanding loans.)[4] A

[3] The tax year in Barclays is 1977; the tax years involved in the current administrative review of amicus commences in 1976.

[4] Alternatively, a taxpayer can compute its addition to the reserve by using a three or six year moving average of loss experience.

bank seeking to apply this "facts and circumstances" test must review the creditworthiness of:

> 1. Its largest loans not to represent less than 10% of its total loan portfolio, *on an individual basis;*
>
> 2. A random selection of a reasonable percentage, not to be less than 5% of a particular class or classes of loans, such class or classes of loans to represent at least 50% of its remaining loan portfolio; and
>
> 3. The historic loan loss experience of the remaining loans determined pursuant to the method allowed in subparagraph 1. of paragraph (A) [i.e., a six year moving average] without consideration of the specific loans, class or classes of loans for which a specific or sampling review was made pursuant to subparagraphs 1. and 2. of this paragraph. Cal. Code Regs. tit. 18, § 24348(b)(3)(C). (Emphasis added.)

As applied to Barclays, where about 1.5% of its worldwide activity is conducted in California and 2% is conducted in the U.S., a specific review on an individual loan by loan basis of 10% of the total worldwide loan portfolio starts the facts and circumstances analysis, followed by review of 5% of classes of smaller loans, *plus* construction of a six year moving average loss experience for the remaining loans. U.S. banks have the data that enables them to shoulder this burden. To obtain comparable treatment with respect to the bad debt deduction, foreign based banks must analyze and produce loan documents, credit reports, internal loan quality review documents, regulatory action, and independent auditor's reports from all over the world. Barclays and its subsidiaries

operated in over sixty countries and territories. Jt. Stip. of Facts, paragraph 8. In the case of Amicus, most of these records are in French, which must be translated by either the taxpayer or the FTB.

The second example illustrates the additional burden faced by a foreign bank in computing its apportionment factors. Both foreign parent groups and domestic parent groups look to Cal. Code Regs. tit. 18, §§ 25137-6(c)(1)(A) and (C) for rules determining the property factor of the apportionment factor. This regulation provides that fixed assets for foreign based taxpayers are valued at original cost as defined under U.S. accounting standards and translated at the exchange rates as of the date of acquisition. However, financial assets are translated at current year-end rates, even though no gain or loss is allowed from historic rates. In general, a U.S. based taxpayer has no problem in determining the original dollar cost and date of acquisition of fixed assets, for those records are maintained in the ordinary course of business. However, for foreign assets of foreign parents, and for subsidiaries of foreign parents, it is necessary to review, and construct if necessary, records that show the date that each fixed asset was acquired. Moreover, the foreign based taxpayer must also determine the original foreign currency cost of each asset (applying U.S. concepts of capitalization of expenses to original cost), and then determine and apply the applicable exchange rate.

The consequences of these differences is that the foreign parent will find it difficult or impossible to compute income subject to apportionment, or to determine the apportionment formula, on a basis that is available to domestic based taxpayers. In contrast to domestic based

taxpayers, foreign based taxpayers are dependent upon the administrative mercy of the FTB, which may or may not be forthcoming, to accept information that is generally not recorded or prepared in a manner consistent with California tax principles. The process is inherently frustrating for foreign parents and for foreign governments.

B. Foreign based taxpayers are taxed on a different measure of income subject to apportionment than domestic based taxpayers, assuming identical transactions and activities.

Cal. Code Regs. tit. 18, § 25137-6(b) provides that the measure of taxable income in a foreign parent combination shall be calculated in the currency in which the parent company maintains its books and records, and then translated into dollars at current exchange rates. Depreciation, depletion, and amortization are translated at historic exchange rates, however. These rules cause identical transactions by a domestic group and a foreign group to be treated differently for California tax purposes where there are changes in the exchange rate.

Take, for example, the bad debt deduction of banks such as Barclays and Amicus. Suppose two loans of equal value are made in 1979, the first a $100 loan by a U.S. bank denominated in U.S. dollars, and the second a Ffr. 400 loan by a French bank denominated in French francs when the exchange rate is 4:1. In 1984 when the exchange rate is 8:1 the loans are written off. The dollar denominated loan (which is how U.S. banks account for loans) produces a deduction of $100. However, the Ffr. 400 loan (which is how the FTB accounts for the loss of the French

bank loan) produces a deduction translated, at 8:1 of only $50. Thus, where the value of the dollar increases with respect to the value of the currency of the foreign country, foreign income is overstated on identical transactions. This result is proscribed by *Kraft General Foods, Inc. v. Iowa*, 112 S.Ct. 2365 (1992), where this Court held that an Iowa statute granting a corporation a deduction for dividends received from a domestic corporation and denying a deduction for dividends received from a foreign corporation facially discriminated against foreign commerce and violated the Foreign Commerce Clause.

Where the value of the dollar decreases with respect to the value of the currency of the foreign parent country, the California regulations cause the foreign income to be understated as compared to U.S. dollar accounting.[5] If exchange rates fluctuate within moderate limits, the distortions may tend to offset each other. However, if foreign income is earned in highly inflationary economies, overstatement of income is inevitable.[6]

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[5] A California Court of Appeals has held that a property tax exemption for goods in foreign commerce is invalid, not because there is a discrimination against foreign commerce, but because there is a discrimination in favor of foreign commerce. *Zee Toys, Inc. v. Los Angeles*, 85 Cal.App.3d 763, 149 Cal.Rptr. 750 (1978), *aff'd by an equally divided court sub nom. Sears, Roebuck & Co. v. Los Angeles*, 449 U.S. 1119 (1981). Thus, discrimination against foreign commerce and discrimination in favor of foreign commerce are per se violations of the Foreign Commerce Clause.

[6] The accounting profession has struggled with foreign income translation. *See* generally, *FOREIGN CURRENCY TRANSLATION*, Statement of Financial Accounting Standards No. 52 (Am.Inst. of Certified Pub. Accountants (1981)), which

The California regulations provide a different measure of income for foreign parents in all cases where an item of income or expense is determined by reference to a tax basis of an item that is valued in a prior period when a different exchange rate existed. Besides depreciation, depletion, amortization and the bad debt deductions, other examples of this inherent defect include the valuation of inventory in computing gross profit from sales and the calculation of gains and losses on the sale of property.

It might be argued that the California scheme of combining foreign parent income, while not perfect, falls within the range of reasonable approximation recognized as acceptable in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983). However, there is a clear distinction between discrimination against foreign commerce in determining income, which is unconstitutional, and rough approximation in apportionment, which is valid. There is no authority or policy that justifies taxing subsidiaries of foreign parents on an income base different from an income base used for taxing a U.S. parent or a

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replaced *ACCOUNTING FOR THE TRANSLATION OF FOREIGN CURRENCY TRANSACTIONS AND FOREIGN CURRENCY FINANCIAL STATEMENTS*, Statement of Financial Accounting Standards No. 8 (Am.Inst. of Certified Pub. Accountants (1975)). Under paragraph 11 of FASB 52, financial statements of a foreign entity in a highly inflationary economy is remeasured as if the functional currency were the reporting currency. A highly inflationary economy is defined as one that has cumulative inflation of approximately 100 percent or more over a 3-year period. This remeasurement is necessary to avoid gross overstatement of income earned in high inflation countries. Cal. Code Regs. tit. 18, § 25137-6, *supra*.

subsidiary of a U.S. parent, assuming identical transactions. A California scheme that allows a $100 deduction for a loss on a loan denominated in dollars, but only a $50 deduction for a loss on a loan denominated in French francs that was the monetary equivalent of a $100 loan when made, facially discriminates and is invalid under *Kraft, supra.*[7]

A fundamental flaw in the worldwide combined return concept applied by the FTB is that foreign parent combinations are taxed on a different measure of income than are domestic parent combinations, assuming identical transactions and changes in the exchange rate.

C. Foreign based taxpayers are subject to discriminatory treatment in the apportionment formula where differences exist in the political economy.

Foreign based taxpayers also are subject to discriminatory treatment in calculation of the apportionment formula. For example, the payroll factor in California is based upon amounts paid to employees. Section 1500 of the Foreign Parent Handbook issued by the FTB (June 1992 ed.) provides that in computing the denominator of the payroll factor for foreign employees not subject to the Internal Revenue Code the determination of whether benefits would constitute income to the employee shall be

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[7] For a more extensive discussion of the problems arising when changes in the foreign exchange rate occur, see Roy E. Crawford, "Currency Exchange Problems in California's Worldwide Unitary Taxation," Bulletin of the International Bureau of Fiscal Documentation, August-September 1986, pp. 378-384.

made as though such employees were subject to the Internal Revenue Code. Thus, under a political system where an employer pays employment taxes to the government, which in turn uses the funds to provide enhanced benefits to employees (which would not be taxable under the U.S. Internal Revenue Code), the FTB reduces the amount of actual foreign payroll costs incurred in the denominator of the payroll factor. The difference in political economy results in discriminatory treatment against foreign based taxpayers in computing the apportionment formula.

D. Because most of the economic activity of foreign parents is likely to be outside the U.S., while most of the economic activity of a U.S. parent is likely to occur in the U.S., the increased administrative burden of accounting for foreign income falls disproportionately on subsidiaries of foreign parents. In addition, the distortion in the measure of income arising from exchange rate changes and the discrimination in the apportionment formula applies to a higher percentage of economic activity for foreign parents than for domestic parents.

Only about two percent of the operations of Barclays were in the U.S., and a smaller percentage was located in California. Ninety-eight percent of the economic activity was in foreign countries. In contrast, in *Container Corp. of America v. FTB, supra*, the U.S. activity in this domestic parent combination was about 77%, foreign activity

accounting for about 23%.[8] These percentages illustrate the likelihood that most economic activity of foreign parents with U.S. subsidiaries will be outside the U.S., while most of the economic activity of a U.S. based multinational group will be in the U.S.

There are three practical consequences of this difference. First, the relative burden of converting foreign financial accounting records into California tax accounting reports for Barclays applies to economic activity outside the U.S. 50 times the economic activity in the U.S., while in Container the burden applies to economic activity outside the U.S. that was less than 1/3 of the economic activity in the U.S.

Second, the disparate treatment in determining income where there have been changes in the exchange rate applies to 98% of the economic activity in the income base for Barclays, in contrast to 23% for Container.

Third, the discrimination in the apportionment formula for foreign based taxpayers applies disproportionately to foreign based taxpayers.

CONCLUSION

The Court should reverse the decision of the Court of Appeal of the State of California for the reason that the worldwide combined return applied to foreign parent

[8] In 1965 Container's tax return as filed apportioned 9.8336% of income to California. The NPAs increased income subject to apportionment, and reduced the California share to 7.6528%. *Container Corp. of America*, 463 U.S. at 174-175.

combinations discriminates against foreign commerce and results in an enhanced risk of multiple taxation of foreign commerce. The unfair burdens and uneven treatment of foreign based taxpayers provide the substantive basis for the foreign outcry that has emerged protesting this deviation from international standards.

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Respectfully submitted

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